Supreme Court, U.S.
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No. 05-1664

IN THE

Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION,

Petitioner,

v.

UNITED AIR LINES, INC.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF

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CORPORATE DISCLOSURE STATEMENT

Petitioner's corporate disclosure statement was set forth at page *ii* of its Petition for a Writ of Certiorari, and there are no amendments to that statement.

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ARGUMENT

United's brief in opposition asserts that "only state-law equitable principles are in dispute." Br. in Opp. 6. But that is not true. The question here is whether the federal courts have the authority, despite the limitations explicit in the Bankruptcy Code and this Court's decision in *Ahlers*, to use equitable principles of any stripe (state or federal) as a remedy to justify changing a result mandated by the provisions of the Bankruptcy Code. Even under United's reading of what happened below, in which the panel majority merely created a new state law equitable principle ("analogically" out of a federal income tax law doctrine), the panel then used that principle — not to find an independent, pre-existing state law property interest — but as a "remedy" to strip U.S. Bank of its offset rights preserved by the Bankruptcy Code. The panel majority determined that the structure created by the Bankruptcy Code to resolve the dispute between the parties was "inadequate" and instead substituted its own newly-minted "state law" equitable remedy to change the result dictated by the Code. This is precisely the kind of judicial activism that this Court reviewed, and struck down, in *Ahlers*.[1]

As carefully pointed out in the Petition, and as carefully avoided in United's response (which never quotes from or even

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1. We granted certiorari to consider the Court of Appeals' application of the absolute priority rule. . . . [W]e find no support in the Code or our previous decisions for the Court of Appeals' application of the absolute priority rule in this case. . . . [W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code. . . . In sum, because we find the decision below to be contrary to the Bankruptcy Code and this Court's previous cases, the judgment of the Court of Appeals is reversed . . . .

Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 202, 206, 211 (1988). *See also id.* at 199 ("Because we find this conclusion [of the Court of Appeals] at odds with the Code and our cases, we reverse.").

refers to these dispositive words of the panel's decision), the panel majority's own words show its work; there is no need to guess (or use United's gloss) here: After concluding that U.S. Bank had breached a contractual duty to United – a duty it concluded was "mutual" and thus subject to "setoff" (App. 16a-18a) – the majority explicitly stated that "[i]n the absence of bankruptcy," it could order the result it considered appropriate: contract-based "damages." App. 19a ("we could simply order U.S. Bank to pay United now and the issue of damages would be resolved"). But the majority conceded that the reason it would not issue such an order was that, in its view, "the bankruptcy filing . . . complicates the matter," because "if we were simply to award United its damages effective today, the money would be subject to the bankruptcy filing. . . ." *Id.* The damages that could be awarded United would be subject to U.S. Bank's setoff rights afforded under the Bankruptcy Code. Accordingly, the panel majority candidly admitted, it was going to see if it could find a way around United's own federal bankruptcy filing: "The question, then, is whether California law contains a remedy that will make United whole." App. 20a.

The question was the wrong one to begin with, since no state law "remedy" can trump a outcome mandated by the Bankruptcy Code; a principal purpose of the Code is to create a structure that (while it frequently looks to state law as the foundation for property rights) displaces state law remedies. But the answer even to the incorrect question was that California law, as the panel majority found it, did not contain such a remedy. The equitable maxim the bankruptcy court had found under existing California law —"that which ought to be done shall be deemed to be done," App. 20a— appeared even to the majority to be "reaching beyond the bounds of this case to force a result." *Id.*

Undeterred, the majority then looked to Justice Holmes' opinion in *Corliss v. Bowers*, 281 U.S. 376 (1930), a decision interpreting the Revenue Act of 1924, and a forty-year-old case

from the Tax Court to find, *sua sponte*, an "apt analogy": the federal income tax "doctrine of constructive receipt." App. 21a and n.6. This it fashioned, in its own words, into an "equitable *remedy*" (not a pre-filing state law property right) to trump U.S. Bank's substantive setoff rights under pre-existing California law and the Bankruptcy Code. *Id.* 23a (emphasis added). It did so despite U.S. Bank's direct protestations, saying "U.S. Bank's characterization of recourse to equity as some rogue *remedy* is baseless. Courts consistently rely on equitable *remedies* where damages at law are insufficient." *Id.* 25a (emphasis added). But here, as the panel's own words show, the only reason the "damages at law" were "insufficient" was because "the money would be subject to the bankruptcy filing" and thus subject to offset. App. 19a.

Granting United an equitable "remedy" supported only by "analogical" reference to a federal income tax doctrine in order to get around the "insufficient" result that would otherwise be compelled by the Bankruptcy Code was patently improper,[2] conflicts with *Ahlers*, and merits this Court's review. The question presented is not, as United pretends, whether the panel's new "analogic" remedy is or is not consistent with California law; the question is whether the panel can use an equitable remedy –state or federal, newly created or respectably old – to trump the result the Code requires when a federal bankruptcy case has been filed.

United's brief in opposition also states that "Section 105 of the Bankruptcy Code, 11 U.S.C. § 105, which gives bankruptcy courts certain equitable powers under federal law, is not implicated here—which may explain why none of the

2. *See Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 24-25 (2000) ("Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides.").

lower courts in this case relied on that provision." Br. in Opp. 6. United misses the point. Section 105 is *the* source of the bankruptcy courts' equitable powers[3] and, therefore, any purported exercise of equitable powers or fashioning of equitable remedies that goes beyond the authority conferred by Section 105 is necessarily improper. A federal court cannot validly exercise an asserted equitable authority to strip a creditor of substantive rights under pre-existing state law and the Bankruptcy Code simply by declining to cite Section 105 and purporting to be acting pursuant to some other source of law.[4] In short, Section 105 is not only the source of federal courts' equitable authority in bankruptcy cases, it is also the limit of such authority.

Finally, there is no gainsaying this case represents only the latest example of a court dissatisfied with a result compelled by the terms of the Bankruptcy Code and justifying a different result based on its purported equitable powers.[5] As the leading treatise on bankruptcy law describes it:

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3. *See* 2 *Colliers on Bankruptcy*, ¶ 105.LH at 105-105 (15th ed. 2006).

4. United inaccurately states that even the dissent agreed that no federal question of equity was implicated by the panel's decision. Once again, the actual words used by the dissent dispel Unity's gloss:

> "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988); *see also United States v. Noland*, 517 U.S. 535, 539, 543 (1996). "There is no general equitable override to the Bankruptcy Code." *In re Payne*, 431 F.3d 1055, 1062-63 (7th Cir. 2006) (Easterbrook, J., dissenting). . . . Application of the [federal] taxation doctrine of constructive receipt is no more supportable than application of the California equity doctrine invoked by the lower courts.

App. 29a, 33a (Sykes, J., dissenting).

5 It is worth noting that United does not dispute that there is dramatic disagreement among the lower courts regarding the scope of (Cont'd)

> The cases and commentary reflect two general schools of thought regarding the breadth of section 105. The first recognizes that certain goals of the Bankruptcy Code are implied but not stated in the statutory language, and views section 105 as granting the bankruptcy courts authority to fill gaps left by the statutory language. The other approach is that section 105 is not a broad writ, and should be narrowly construed.

2 *Colliers on Bankruptcy*, ¶ 105.01[2] at 105-7 (15th ed. 2006); *see also id.* ¶ 105.01[1] at 105-6 ("Efforts to construe this power consistent with this purpose have split the courts.") This case squarely presents the conflict at issue, and provides a clear opportunity for the Court to address the arbitrary administration of justice in the bankruptcy courts that currently prevails based on differing interpretations of the scope of their equity powers.

This Court sits, in part, to supervise the lower federal courts when they have departed from the "accepted and usual course of judicial proceedings" as delimited by statutory provisions and this Court's decisions. Rule 10(a). That power, as it was in *Ahlers*, should again be exercised here.

CONCLUSION

The petition for a writ of certiorari should be granted.

(Cont'd)
authority to resort to equitable principles to justify results contrary to explicit provisions of the Bankruptcy Code, or that further guidance on this issue from this Court is desperately needed. *See* Br. in Opp. 6. United simply seeks to convince the Court that this issue is not actually presented in this case.

Respectfully submitted,

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